Before the
Federal Communications Commission
Washington, D.C. 20554

In the Matter of	)	
	)	
Developing a Unified Intercarrier Compensation Regime	)	CC Docket No. 01-92
	)	

Reply Comments of the Office of the People's Counsel
For the District of Columbia

Pursuant to the Federal Communications Commission's ("FCC") Notice of Proposed Rulemaking ("Notice"),[1] the Office of the People's Counsel for the District of Columbia ("OPC-DC") submits these reply comments regarding the proposed adoption of a unified intercarrier compensation regime. OPC-DC opposes the adoption of a *bill and keep scheme*. Rather, OPC-DC supports the adoption of a regime that is based on reciprocal compensation principles, as it generally promotes a competitive local exchange marketplace, among other benefits.

Summary of OPC-DC's Position

Succinctly stated, OPC-DC submits adoption of a bill and keep compensation scheme will 1) thwart competition and 2) ultimately result in higher residential rates as the incumbent local exchange carriers ("ILECs") pass through costs to the residential consumer.

- OPC-DC agrees with the parties opposing the adoption of a bill and keep regime. OPC-DC does not support a change that would create cross-subsidization between the residential and commercial market.

- OPC-DC opposes a bill and keep regime that will require District of Columbia ratepayers to support the cost of terminating calls originated by end-users outside of the District.

[1] In re Developing a Unified Intercarrier Compensation Regime, CC Docket No. 01-92, Notice of Proposed Rulemaking, Apr. 27, 2001 ("Notice").

- Changing to a unified intercarrier bill and keep regime in the District of Columbia will permit Verizon Washington DC, Inc. ("Verizon D.C.") to collect $19.1 million in access charges from District ratepayers interexchange carriers that were formerly collected from interexchange carriers.

- OPC-DC supports an intercarrier reciprocal compensation regime which will: (1) eliminate regulatory arbitrage, (2) promote competition in the local exchange marketplace, (3) lead to a more efficient, better-invested telecommunications network, and (4) help maintain current levels of residential prices.

Introduction

In this Notice, the FCC requests comments on the concept of relying on a unified bill and keep intercarrier compensation regime. Carriers would no longer bill other carriers for originating or terminating costs. Instead, each carrier would collect its costs from its own end-users. The bill and keep regime would replace reciprocal compensation payments and access charges.

In their initial comments, parties sharply disagreed over the benefits and viability of a bill and keep regime. Parties supporting a bill and keep regime argue that it would mitigate the current regulatory arbitrage opportunities, increase efficiency, and reduce regulatory interference in the market.[2] They also allege that the FCC has the authority to mandate a bill and keep regime for all intercarrier compensation regimes with the exception of state access charges.[3]

Many of the supporting parties suggest that the FCC institute a two-step approach to adopting a bill and keep regime. In the first step, the FCC would mandate the bill and keep regime for reciprocal compensation and for local calls to ISPs. During step two, the FCC would mandate bill and keep for access charges. The second step would occur at the end of

[2] BellSouth Comments at 6-10, QWEST Comments at 12-20, SBC Comments at 14-17, and Verizon Comments at 3-11.
[3] BellSouth Comments at 17, SBC Comments at 43.

the CALLS interim plan. At that time, carriers would be allowed to increase their end-user charges to recover the loss in access charges.[4] The supporting parties also request the FCC to require states to eliminate alleged subsidies to residential customers.[5] Finally, if these changes require carriers to establish extremely high local rates, supporting parties request that the FCC alter its own universal service mechanisms and require the states to alter their programs so that local exchange service remains affordable.[6]

Parties opposing the bill and keep regime argue that the appearance of arbitrage in some markets is in reality the working of competitive market forces. The large flow of funds from the incumbent local exchange carriers ("ILECs") to the competitive local exchange carriers ("CLECs") in the form of reciprocal compensation payments represents reasonable payment for services rendered to the ILECs.[7] The opposing parties also argue that the current calling party network pays ("CPNP") regime, also known as reciprocal compensation, is efficient and that failure to pay the terminating party will result in the confiscation of current facilities and the elimination of the incentive to provide additional facilities.[8]

Opposing parties also argue that the CPNP regime reflects competitive market outcomes. They note that such payments occur in many network industries.[9] Moreover, they assert that changing to bill and keep will have a significant negative impact on competition. It will eliminate a primary revenue stream used by competitors to enter markets dominated by

[4] Sprint Comments at 2, Verizon Comments at 2-3.
[5] SBC Comments at 20, BellSouth Comments at 11.
[6] Level 3 Comments at 30, SBC Comments at 22-24.
[7] ETI, Efficient Intercarrier Compensation Mechanisms for the Emerging Competitive Environment at 24. Sponsored by Focal Communications Corporations, PAC-West Telecomm, Inc.' RCN Telecom Services, Inc. and US LEC Corp. ("Focal"); Office of the Public Utility Counsel of Texas ("TOPUC") Comments at 45. National Association of Utility Consumer Advocates ("NASUCA") Comments at 18-20.
[8] AT&T Comments at 22-26, Maryland Office of the People's Counsel ("OPC-MD") Comments at 24-25.
[9] NASUCA Comments at 8-10, ETI, Efficient Intercarrier Compensation Mechanisms for the Emerging Competitive Environment at 5-10.

ILECs. It will provide the ILECs with opportunities to squeeze out competitors.[10] Finally, it will provide the ILECs with an influx of funds from residential markets that ILECs can use to cross subsidize competitive business markets. The ILECs will receive the influx of funds because the level of competition in residential markets is insignificant.[11]

Opposing parties recognize that the bill and keep regime is inefficient when compared to the current CPNP regime. Incentives associated with bill and keep would reduce the use of the network and lead to a reduction in transport investment. It would also require consumers to pay for calls they do not want and which they find offensive.[12]

In general, OPC-DC agrees with the parties opposing the adoption of a bill and keep regime. OPC-DC recognizes that the goal of the Telecommunications Act of 1996 is to substitute competitive market forces for regulation. However, changing to bill and keep regime will not lead to markets governed by competitive forces. Rather, it will lead to markets governed by monopoly forces. This will occur because CLECs will not be paid for the facilities in which they invested for terminating ILEC calls. Monopoly forces will also govern because ILECs are likely to increase rates in residential markets where they still have substantial market power and lower rates in competitive business and toll markets.

OPC-DC opposes a bill and keep regime because it requires District of Columbia ratepayers to support the cost of terminating calls originated by end-users outside of the District. The consequence of changing to an unified intercarrier bill and keep regime for the District of Columbia ratepayers would be that Verizon D.C. would no longer collect $19.1

[10] Declaration of Janusz A. Ordover and Robert D. Willig on behalf of AT&T,at 28, Focal Comments at 12-16.
[11] AT&T Comments at 26-29, TOPUC Comments at 67-68.
[12] AT&T Comments at 32-33, NASUCA Comments at 25-26, and TOPUC Comments at 92-95.

million in access charges from interexchange carriers.[13] Instead, Verizon D.C. would have the opportunity to collect these revenues from District ratepayers. Based on the approximately 900,000 access lines in the District, if Verizon D.C. were allowed to increase the subscriber line charge ("SLC") to recover the lost revenue, the SLC would increase by $1.77 per month.[14]

Finally, in the post-September 11 era, OPC-DC opposes the adoption of a bill and keep regime because the incentives associated with that regime encourage carriers to under-invest in transport facilities that link one carrier to other. Such under-investment could lead to a disaster in times of emergency when it is essential that federal government agencies, district government agencies and citizens of the District of Columbia communicate with citizens who are served by other carriers. It is incredible in this post-September 11 era that the FCC would adopt a regime that does not encourage significant investment in inter-carrier facilities, and may adopt a regime that will lead to a diminution of these vital communications infrastructure links.

[13] This estimate is based on the Verizon D.C. ARMIS 43-01 report for the year 2000. The estimate is the sum of traffic sensitive switching revenue and half of traffic sensitive transport revenue. Half of transport revenue is used to estimate the originating transport access that would no longer be recovered from interexchange carriers. Terminating transport would be recovered from interexchange carriers under some of the alternative bill and keep regimes suggested by the FCC and various parties.

[14] If Centrex customers were allowed a discount based on a PBX equivalence, then the SLC would increase by $2.45, assuming a 6 to 1 equivalence and 300,000 Centrex lines.

Arguments

I. Under a Reciprocal Compensation Regime, Regulatory Arbitrage Will Not Result in Terminating ISP-Bound Traffic[15].

Regulatory arbitrage occurs when a regulated firm is required to set different prices for products or services with a similar cost structure.[16] In the Notice, regulatory arbitrage also refers to instances when firms take advantage of differences between regulated rates and the underlying cost of service. Thus, it is alleged that because reciprocal compensation rates appear to be too high, terminating networks are not only being compensated for their services but also may be receiving windfall profits. This pricing structure creates the incentive to specialize in serving customers that primarily receive communications, such as ISPs, for the sole purpose of profiting from the excessive reciprocal compensation rates.[17]

QWEST points out that "the most notorious example [of regulatory arbitrage] involves the termination of ISP-bound traffic."[18] Verizon urges the FCC to finish the work it started in the ISP-Remand Order and eliminate carrier compensation for ISP-bound calls.[19] SBC asserts that "the most egregious example of regulatory arbitrage has been CLECs seeking ISP

[15] Calls subject to reciprocal compensation or ISP bound traffic payments originate and terminate in the same local calling area. In the ISP-Remand Order, the FCC defined ISP-bound traffic as "traffic exchanged between LECs that exceeds a 3:1 ratio of terminating to originating traffic." In the Matter of Intercarrier Compensation for ISP-Bound Traffic, CC Docket No. 99-68, *Order on Remand and Report and Order*, FCC 01-131 (rel. Apr. 27, 2001) ("ISP-Remand Order"). The ISP-Remand Order also establishes a FCC rate for that traffic. *See* ISP-Remand Order at ¶ 8. However, the order did not transfer the ILEC cost of associated with ISP bound traffic into the interstate jurisdiction. Rather it let stand the separations freeze. In the Matter of Jurisdictional Separations and Referral to the Federal-State Joint Board, CC Docket No. 80-286, *Report and Order*, FCC01-162 (rel. May 22,2001) ("Separations Order") at paras. 34-42. We urge the FCC to revisit its separations freeze in order to transfer costs associated with ISP bound traffic into the interstate jurisdiction.

[16] Notice at fn. 18.

[17] Notice at 11.

[18] QWEST Comments at 16.

[19] Verizon Comments at 3.

customers with high volumes of one-way traffic in order to generate billions of dollars of reciprocal compensation payments." [20]

OPC-DC recognizes that there is a considerable flow of funds from the ILECs to the CLECs involving reciprocal compensation payments associated with ISP bound calls. However, these payments are not the result of regulatory arbitrage. For arbitrage to exist, there must be a regulatory constraint that requires that the price paid by ILECs for terminating traffic on CLEC networks be higher than the ILECs' cost of service. No such constraint exists. The rates for transport and terminating service are set on the basis of the ILECs' cost in accordance with the Total Element Long Incremental Cost ("TELRIC") methodology.[21]

It has also been suggested that the difference between the ILECs' cost of service and the CLECs' cost of service is the source of the arbitrage.[22] This suggestion is simply wrong. In competitive markets, the price is set according to demand and supply conditions. The supply conditions reflect the cost of all carriers supplying the service. The price reflects the cost of the highest cost supplier for which the market demand is willing to pay. Lower cost suppliers will earn economic profits.[23] Therefore, when the price is set at the ILEC cost and the ILEC cost is higher than the CLEC, it is consistent with the operation of competitive markets for CLECs to earn economic (extra-normal) profits. Moreover, ratepayers undoubtedly prefer to have CLECs perform the transport and termination tasks because resources are conserved by using the lower cost provider, which typically, in turn, results in

[20] SBC Comments at 15.
[21] In the Matter of the Implementation of the Local Competition Provisions of the Telecommunications Act of 1996, CC Docket No. 96-98, *First Report and Order* (rel. Aug. 8, 1996) ("Local Competition Order") at ¶¶ 1046-1068.
[22] Verizon Comments at 4.
[23] A. Kooutsoyiannis, Modern Microeconomics (Second Edition, 1979) at 160-63.

lower rates. Finally, setting the price at ILEC cost provides an incentive for the ILEC to become more efficient. This incentive drives the ILECs to reduce cost in order to reduce their payments to CLECs. Without this incentive, the ILECs will be insulated from the pressure to engage in efficient cost-minimizing operations.[24]

Instead of engaging in arbitrage profit-seeking, CLECs have entered the market to serve ISPs as the foundation to their general entry into local exchange markets. Serving fast-growing niche markets is a typical activity of any firm entering a market dominated by existing firms.[25] Thus, it is acceptable normal competitive market behavior for CLECs to serve ISPs.[26] Simultaneously, ISPs have gravitated toward CLECs because historically ILECs have not provided the ISPs with reasonable service.[27] ISPs receive significant cost savings when they can collocate in wire centers. CLECs offer collocation service to ISPs. ILECs do not. Moreover, ILECs have constantly sought to leverage their dominance in the local market into a large share of the enhanced services market.[28] Given the behavior of the ILECs and the rational business plans of the CLECs, it is reasonable to find CLECs dominating the market for ISP service.

II. Reciprocal Compensation Promotes Competition.

In general, all parties would agree with the statement that the Commission "should chose a rule that is designed to accommodate, rather than frustrate the development of full-blown

[24] ETI, Efficient Intercarrier Compensation Mechanisms for the Emerging Competitive Environment, at 24. Sponsored by Focal.
[25] Many examples of entry strategies of small firms can be found in Clayton M. Christenen, The Innovator's Dilemma, 1997.
[26] F.M.Scheer and Daniel Ross, Industrial Market Structure and Economic Performance, Third Edition, 1990, at 392; NASUCA Comments at 19.
[27] NASUCA comment at 20.
[28] Office of Public Utility Counsel of Texas Comments at 27. Also, for example, in many jurisdictions, the rate for ILEC DSL service is the same whether the customer uses the ILEC's affliate ISP or an independent ISP. Use of the independent ISP, therefore, requires the payment of two fees, the DSL charge and the independent ISP charge.

competition."[29] The parties, however, disagree as to whether a CPNP or bill and keep regime should be the appropriate rule. As we noted above, with regard to reciprocal compensation and ISP bound traffic, the CPNP regime promotes competition, while bill and keep would frustrate competition. Therefore, we urge the Commission to retain the current CPNP regime.

Generally, two problems associated with access charges have been addressed in the initial comments. First, the problem of terminating access monopoly, and second, if bill and keep is adopted, the problem of how ILECS should be allowed to recover the lost revenues.

Terminating access monopoly refers to the situation where a customer's LEC is the only carrier who can terminate a call to that customer. If the LEC increases the terminating access charge, the IXC must pay that charge. There are at least two ways to prevent abuse of terminating access monopoly power. First, the terminating rate can be regulated. In the case of ILECs, regulating the terminating rate has been a contentious issue but one that regulators and the parties have learned to overcome.[30] Some parties assert that determining just the right rate is extremely difficult and, therefore, regulators should no longer try. Those parties note that it is not clear if the rate should be based on per-minute usage or on capacity requirements.[31] While these difficulties do exist, they are not insurmountable. [32]

For CLECs, instead of directly regulating their rate, the FCC has recently adopted the rule that the CLEC can charge the terminating rate of the ILEC in the calling area where the

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[29] QWEST Comments at 8.
[30] *See*, in general, In the Matter of Access Charge Reform, Price Cap Performance Review for Local Exchange Carriers, Low-Volume Long-Distance Users, Federal–State Joint on Universal Service, FCC 00-193, (rel. May 31, 2000)("CALLS Order").
[31] Regulators divide energy charges for large users between usage (KWH charges) and capacity (KW charges). Telephone regulators must realize that the capacity charge is separate from the customer charge, where the customer charge is equivalent to a per-line telephone charge.
[32] NASUCA Comments 16-18.

CLEC is operating.[33] Such a rule appears to provide the CLEC with a reasonable recovery mechanism. It also provides the CLEC with an incentive to reduce its terminating costs because the CLEC is allowed to keep the difference between its terminating costs and those of the regulated ILEC. The rule also protects the IXC because the IXC is no longer subject to the whims of the CLEC that could exert its monopoly power and charge excessive terminating rates.

The second way to prevent abuse of terminating monopoly power is to adopt a bill and keep regime. The monopoly power cannot be abused because the charge for terminating is prohibited by regulatory fiat. However, the ILECs that provide the terminating service no longer have a revenue source from which to recover their terminating costs. For this reason, ILEC support for bill and keep is contingent on the right to increase end-user rates to replace the access revenue reduction.[34]

While increases in end-user rates could replace loss access revenue, there are a number of problems with this solution. First, the amount required is very large and will have a significant impact on the affordability of telephone service. In the District, the increase would be at least $1.77 per access line monthly. Sprint estimates that Tier 1 LECs (large carriers that file ARMIS reports) would have to increase charges by approximately $4-$5 per access line monthly.[35] Rural carriers face even higher rate increases.[36] This solution, therefore, requires a large shift income from the cost causers of long distance service to the average local exchange end-user. Second, transport and termination charges are traffic

[33] In the Matter of Access Charge Reform; Reform of access Charges Imposed by Competitive Local Exchange Carriers, CC Docket No. 96-262, *Seventh Report and Order*, FCC 01-146 (rel. Apr. 27,2001) ("CLEC Access Charge Order").
[34] QWEST Comments at 17, BellSouth Comments at 15, SBC Comments at 31, Verizon Comments at 13.
[35] Sprint Comments at 24.

sensitive, either on a per-minute basis or a capacity basis.[37] Recovering these charges on a per-line basis is inefficient and would reduce consumer welfare.

Third, per-line recovery will also interfere with the competition between IXCs and ILECs. It will allow the ILECs to engage in an anti-competitive price squeeze. A consumer can purchase the bundle of originating access and long distance service from the ILEC or can purchase originating access from the LEC and inter-city transport from the IXC. If the ILEC sets the rate for access above cost, it can use that extra-normal profit to reduce its inter-city transport rate. The option is not open to the IXC because the above cost access rate is a real cost to the IXC. A price squeeze will exist as the ILEC reduces its inter-city rate to a level below the cost of inter-city transport. [38]

Fourth, given that ILECs continue to dominate residential markets, allowing the ILECs to increase residential rates provides the ILECs with deep pockets that are not available to the CLECs – the residential ratepayer. The increase in funds will provide the ILECs with the ability to outlast any competitor in a price war. It will also allow them to design pricing packages that will attract customers away from competitors. Such price discrimination could be beneficial if the rival carriers were equals. However, when the rivals are a very large ILEC and a start-up CLEC, price discrimination in the form of pricing packages is usually a mechanism for maintaining market dominance. [39]

Pricing packages are also defended as menus that provide consumers with greater benefits because they provide bundles of services in increments desired by consumers. Because such packages are used in the wireless industry, QWEST suggests suggest that the

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[36] *See, e.g.*, Regulatory Commission of Alaska Comments at Table 3.
[37] Verizon asserts that access charges should be recovered on a per-minute basis. *See*, Verizon Comments at 21.
[38] Declaration of Janusz A. Ordover and Robert D. Willig on behalf of AT&T, at 28.

Commission should allow wireline carriers the same opportunity.[40] However, there are significant differences between the wireless and the wireline industry that clearly demonstrate that such packages will not have the same impact in the wireline industry. First, there is a reasonable level of competition in the wireless industry. This competition is the result of the deliberate actions of the FCC. There are now six major carriers in most domestic markets. As more competitors entered the markets, prices have decreased from 58 cents per minute in 1993 to 21 cents per minute in 2000.[41] This level of competition, especially for residential customers, does not exist in the wireline industry.

Second, the wireless industry does not settle intercarrier charges on a bill and keep basis. Rather, it maintains a complex negotiated set of roaming charges. Roaming charges are added to calls off-network to pay for the use of another carrier's network.[42] In many instances, roaming charges exceed the cost of all other charges related to the call.

Third, the wireless industry is reducing the cost of purchasing the cell phone. For example, Cingular offers a second phone free when the customer purchases the first phone for $69.99.[43] Verizon D.C. provides three free phones to a customer who purchases the first phone at $29.99.[44] The cell phone is the part of the wireless network that is dedicated to the individual customer. It is the equivalent of the non-traffic sensitive portion of the loop in the wireline industry. The wireline industry, with the approval of the FCC, asserts that the SLC (a flat per-line charge) is the optimal mechanism for recovery of the non-traffic sensitive portion of the loop. Gradually, over a multi-year process, SLCs have increased and per-

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[39] William G. Shepherd, The Economics of Industrial Organization, 330-35.
[40] QWEST Comments at 33.
[41] Thomas J. Sugrue, Opening Remarks at the June 20, 2001 FCC meeting. See slides 4,5 and 8.
[42] NASUCA Comments at 12-14.
[43] The Washington Post, Tuesday, October 23, 2001, A3.

minute charges have decreased.[45] However, if the wireline industry desires to mimic the wireless industry, it should be lowering SLCs rather than raising them. Lowering SLCs is consistent with competitive market outcomes. In competitive markets, firms seeking market share will not be able to charge customers for the simple right to be connected to their networks.[46] Thus, experience shows that regulators can impose SLCs on customers, monopolists can extract SLCs, but competition will eliminate SLCs. Moreover, as long as competition does not exist, allowing carriers to increase SLCs will delay the creation of a competitive local exchange market.

III. Reciprocal Compensation Leads to a More Efficient, Better-Invested Network.

An examination of the comments shows that a CPNP intercarrier compensation regime leads carriers and end-users closer to an efficient outcome than a bill and keep intercarrier compensation regime. Therefore, we urge the Commission to retain the CPNP regime.

Economic efficiency requires that goods and services be produced in the least cost manner and that the price paid by the end-users be based on the costs associated with their use of the network.[47] With most goods, the person who consumes the product is responsible for paying for it. However, when the consumption of the product causes someone else to also consume the product or part of the product, then the consumption by the second party is

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[44] The Washington Post, Wednesday, October 24, 2001, at A3.

[45] *Universal Service Monitoring Report*, CC Docket No. 98-202, Sept. 2000, Prepared by the Federal and State Staff for the Federal-State Joint Board in CC Docket No. 96-45, Table 7.15: Interstate per-minute access charges; Table 7-14:Interstate Per-Line Access Charges.

[46] Suzanne Scotchmer, "Two-tier pricing of shared facilities in a free-entry equilibrium", Rand Journal of Economics, 16(4), Winter 1985, 456-72. *See* also Arthur W. Lewis, Overhead Costs: Some Essays in Economics, 1970, p.56-7.

[47] Affidavit of Professor Jerry A. Hausman, Attached to the Bell Atlantic Comments In re the Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, CC Docket No. 96-98 ("Hausman Affidavit") at 1; and Declaration of Janusz A. Ordover and Robert D. Willig on behalf of AT&T Corp.("Ordover and Willig Declaration") at 13.

external to the original transaction, and is called an externality. A typical example of an externality is the exhaust from driving a car. One person buys the car and the gasoline and drives the car. Anyone else who breathes the air also consumes that gasoline. Because there is a cost to breathing the polluted air (a shorter life), the externality is called a negative externality. If there is benefit to the consumption, the externality is labeled a positive externality.

In the case of telephone calls, the conversation is jointly consumed by the calling party and the called party. It also jointly produced by the calling party's network and the called party's network. If the parties are charged more or less than each benefits from the call, then an externality is produced. A good solution to this problem would be to choose the rule that maximizes the positive externalities and minimizes the negative externalities. It also is necessary to ensure that both networks are paid for the cost of transmitting the call.

Inside the economic textbook world, the optimal solution is to measure the benefits of the call to each party and split the cost of the call between parties on the basis of the relative benefits. Obviously it is not possible to measure these benefits with respect to a telephone call. For some calls, the calling party receives most of the benefits; for other calls the benefits are split; for yet a third group of calls, only one party enjoys positive benefits and the other party is hurt by the call.

In the initial comments, most of the commenters recognized that neither the CPNP regime or the bill and keep regime exactly matches the need to split the cost according to the benefit received from the call. AT&T and NASUCA point out that the CPNP regime is more flexible than a bill and keep regime. Even though the calling party pays for the entire call, if there are positive benefits to both parties, then the parties can trade calling in accordance

with the relative benefits. If the benefits are negative to the called party, forcing the calling party to pay for all of the calls will reduce the number of negative calls made. If the called party receives most of the benefit, it is possible for the called party to pay for the call using an 800 number or a collect call.[48]

QWEST and BellSouth rely on the fact that calls are jointly consumed to support the bill and keep regime.[49] The bill and keep scheme will split the cost of each call evenly between the calling and called party. They do not show, however, how a 50/50 split of the cost matches the relative benefits of the call to the calling and to the called party. Because bill and keep mandates the 50/50 split for all calls, it clearly can not be efficient when the benefits do not occur in a 50/50 manner.

Parties supporting bill and keep do not dispute that bill and keep will require called parties to pay for calls they do not want. Instead, QWEST suggests that the called party buy additional services to block these calls.[50] This suggestion forces the person who is hurt by the transaction to internalize the negative externality by requiring payment of additional costs to prevent it. This is the opposite of what economic theory suggests is efficient. Economic theory requires the party causing the negative externality, in this case the calling party, to internalize the negative externality.

Sprint asserts that the negative externality will not occur too often because carriers do not have an incentive to seek out tele-marketers as customers. It bases its analysis on a comparison of ILEC carriers' cost before and after the switch to bill and keep.[51] However, this is the wrong comparison. The correct comparison is between the ILEC cost and the

[48] AT&T Comments at 22-24, NASUCA Comments at 21-22.
[49] QWEST Comments at 20, BellSouth Comments at 10.
[50] QWEST Comments at 39.

CLEC cost. In the current regime, CLECs seek ISPs because serving ISPs is profitable. The profits occur because the CLEC terminating cost is less than ILEC TELRIC price. If the CLEC costs were higher than TELRIC, then even in a CPNP regime, CLECs would not seek to serve ISPs. If the FCC were to adopt bill and keep, then CLECs would only seek tele-marketers as customers if their costs of providing originating service was less than the ILEC rate. If the CLEC cost were greater than the ILEC, it would lose money serving the tele-marketers. In a CPNP, the CLEC will only serve tele-marketers if its originating costs are less than the sum of the ILEC rate for originating and the ILEC rate for terminating traffic. This is a much steeper hurdle over which to jump. Thus, switching to bill and keep makes tele-marketing customers more attractive to CLECs and significantly increases the occurrence of negative externalities.

Efficiency also requires non-traffic sensitive costs to be recovered through flat charges and traffic sensitive costs to be recovered through per-minute charges.[52] If the FCC adopts bill and keep for reciprocal compensation, carriers must obtain permission to recover this lost revenue from their state commissions. As Ordover and Willig point out, many state commissions do not have the authority to establish traffic sensitive rates for local service. This implies that a uniform bill and keep regime will transform the current traffic sensitive rate for terminating and transport into a non-traffic sensitive rate, creating an inefficient rate structure.[53]

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[51] Sprint Comments at 8-13.

[52] The measure of traffic sensitivity is under dispute. Transport and terminating cost could be related to either usage on per-minute 24 hour a day basis or usage during the peak period. However, it is clear that traffic, rather than the number of customers, determines transport and terminating facility requirements. *See also,* NASUCA Comments at 23-24.

[53] Ordover and Willig Declaration at 11-12.

Finally, if prices do not cover the cost of network to network transport and termination facilities then carriers will have the incentive to under invest in these facilities.[54] Recognizing this problem, large local exchange carriers have suggested that end-users rates replace reciprocal compensation.[55] Under conditions of competition, however, the substitution of end-user charges for intercarrier payments will also discourage investment. Carriers, attempting to keep rates down in order to attract consumers, will reduce investment in network to network facilities. This lack of investment might not be noticeable under normal traffic conditions. During emergencies this lack of investment could aid to a disaster. In this post-September 11 environment, it is not good public policy to be waiting for communications disasters to occur. Instead, OPC-DC urges the FCC to retain CPNP because this regime, by ensuring full payment for transport and terminating facilities, will encourage optimal investment in these facilities and prevent communications disasters.

IV. Prices for Residential Local Service Will Rise Under a Bill and Keep Scheme.

SBC asserts that prior to adopting a bill and keep regime, the FCC "should focus on increasing residential services prices to levels that are self-supporting."[56] To do so will eliminate current implicit subsidies that flow from vertical, toll, switched access and business services to residential service.[57] It also asserts that the 10th circuit decision in *QWEST v. FCC* requires the FCC to direct the states to remove implicit subsidies in state rates.[58] SBC's assertions are flawed because it has not provided any evidence showing that residential

[54] Hausman affidavit at 5.
[55] *See e.g.*, QWEST Comments at 31 and BellSouth Comments at 15.
[56] SBC Comments at 21.
[57] Id., at 9.
[58] Id, at 22.

customers are receiving a subsidy. Further, SBC simply expands the 10th Circuit's decision to match its own end.

SBC asserts that residential rates are too low because many of these rates have not been changed in ten years.[59] However, if prices are held constant and costs have been falling, then a constant rate is an excessive rate. The telephone industry is a declining cost industry. Significant price decreases in the cellular industry,[60] in toll rates,[61] and in access rates[62] suggest the cost of service is declining. In such an industry, holding the price of residential service constant implies, if anything, that the rate is too high. Moreover, the price of residential service has not been held constant. It has increased from $12.36 in 1990 to $13.64 in 2000.[63]

SBC does not define what it means by "self-supporting." In general, telephone services are produced jointly. If self-supporting means separate from joint production, then SBC is requiring that residential rates be above the stand-alone cost of service. However, that requirement does not match the generally accepted definitions of a subsidy. The commonly accepted definitions for services that are either receiving or producing a subsidy are the following: "A service that is priced below its total service long run incremental cost is receiving a subsidy. A service that is priced above its stand-alone cost is producing a

[59] Id at 9.
[60] Thomas J. Sugrue, Opening Remarks at the June 20, 2001 FCC Meeting, slide 5.
[61] FCC Industry Analysis Division Common Carrier Bureau, *Trends in Telephone Service*, August 21, 2001, Table 14.5: Indicators of Long Distance Prices.
[62] *Universal Service Monitoring Report*, CC Docket No. 98-202, September 2000, Prepared by the Federal and State Staff for the Federal-State Joint Board in CC Docket No. 96-45, Table 7.15: Interstate per-minute access charges.
[63] FCC Industry Analysis Division Common Carrier Bureau, *Trends in Telephone Service*, August 21, 2001, Table 14.1: Average Residential Rates for Local Service in Urban Areas, 1986-2000.

subsidy."[64] Thus, prices that are self-supporting are prices that are above the stand-alone cost of service. Such prices generate subsidies.

Moreover, seldom have carriers provided evidence that any service price is less than its incremental cost or above its stand alone cost. For example, the USTA study of the impact of competition on residential service claimed that toll service paid a subsidy. However, the study only showed that the toll service rate was greater than the incremental cost of service. It never calculated the stand-alone cost of toll service. Thus, the study demonstrated that toll did not receive a subsidy. It demonstrated that toll service was making a contribution to the recovery of the joint and common costs of providing telephone service. It did not show that toll service is providing a subsidy because there was no evidence that toll service rates were above the stand-alone cost of service.[65]

The study also claims that residential service is being subsidized. The basis for this claim is an embedded cost study in which 100 percent of the loop is assigned to residential service.[66] The subsidy claim is wrong for two reasons. First, while embedded cost is important for many reasons, embedded cost does not measure economic subsidies. Second, if the study were an economic study and 100 percent of the loop had been assigned to residential service, the study would have been closer to a stand-alone cost study than to an incremental study. While a rate above the stand-alone cost implies the service is producing a subsidy, a rate below the stand-alone cost does not imply anything about the subsidy payments.

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[64] Gerald Faulhaber, "Cross-Subsidization: Pricing in Public Enterprise," American Economic Review, 1975, 966; William Baumol and Gregory Sidak, Toward Competition in Local Telephony, 1994.
[65] United States Telephone Association, Potential Impact of Competition on Residential and Rural Telephone Service, July 21, 1993.

In Section 271 proceedings, comparisons are made between retail rates and TELRIC estimates to determine the reasonableness of the UNE rates.[67] Comparing a rate to the TELRIC estimate for an element, however, will not support a subsidy claim. Unbundled network elements are inputs in production. Each element can be used to produce many services. The total cost of the element must be allocated to each service that it helps to produce.[68] Thus, the service is only responsible for the recovery of part of the element, and it would be reasonable for any individual service rate to be less than the sum of the element costs used in producing that service.

Recently, the New Mexico Public Regulation Commission (NM-PRC) investigated whether residential service was being subsidized.[69] The NM-PRC used the definition of a subsidy noted above as its rule for determining whether any service was receiving a subsidy. It found "that, inasmuch as the loop is a cost shared by a whole host of services – including, among others, basic exchange, toll, switched access, vertical services, and high frequency data services – the cost of the loop is not directly attributable to basic exchange service."[70] This implied that loop costs were not part of the TELRIC of basic exchange service. On the basis of these findings, the NM-PRC found that the residential basic exchange service was not being subsidized and was making a contribution toward the shared costs of the network.[71]

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[66] The availability of data services that are provided jointly with exchange services requires the assignment of part of the loop to data services in an embedded cost study. This requirement may not be recognized because the FCC has postponed its review of the separations rules associated with such loops. Separations Order at para. 31.
[67] In the Matter of Application of Verizon New England Inc., Bell Atlantic Communications, Inc,, NYNEX Long Distance Company, And Verizon Global Networks Inc., For Authorization to Provide In-Region InterLATA Services in Massachusetts, *Report and Order*, CC Docket No. 01-9 (rel April 16, 2001) at 41.
[68] Haufman affidavit at 3-4.
[69] In the Matter of the Identification of all Subsidies in the Existing Rates of QWEST, F/K/A U.S. West Communications, Inc., Pursuant to HB 400, Utility Case No. 3325, *Final Order*, Before the New Mexico Public Regulation Commission.
[70] Id. at 8.
[71] *Id*. at 8-10.

With regard to SBC's assertion that the FCC must prod the states into increasing basic residential local service rates, SBC is incorrect. Notwithstanding the general prohibition forbidding the FCC from interfering in state ratemaking activities embodied in Section 47 U.S.C. 152(b) of the Telecommunications Act, the plain language of Section 254(k) states that "[S]tates, with respect to intrastate service, determine the reasonable share of joint and common cost assigned to individual services. As discussed above, it is the assignment of the joint cost of the loop that determines whether a service is receiving a subsidy. That assignment is the state's responsibility. Therefore, the 10th Circuit's decision does not cede to the FCC the authority to determine a minimum size state universal fund, where the fund size must be large enough to provide for FCC determined implicit subsidy levels. Rather, once the states have determined for themselves the size of the fund, the FCC should ensure that states establish reasonable universal service fund mechanisms as soon as possible.

Moreover, even though it is preferable, the court does not require a reasonable state universal service fund mechanism to eliminate all implicit subsidies. This conclusion may be implied from the court's discussion of the words "shall " and "should." The court notes that Congress uses both words in Section 254, and does so intentionally. The court understands the word "shall" to be a mandatory duty, while the term "should" indicates a recommended course of action, but does not itself imply the obligation associated with "shall." [72]Section 254(e) states "[a]ny such support ***should*** be explicit and sufficient to achieve the purposes of this section.(emphasis added)." Thus, turning implicit subsidies into explicit subsidies is a recommended policy, not a mandatory policy.

[72] QWEST v. FCC, No. 99-9546 http://www.kscourts.org/ca10/07/99-9546.htm at 8.

V. The FCC Does Not Have the Authority to Mandate a Bill and Keep Intercarrier Compensation Regime.

There are three questions linked to this issue. First, can any commission, state or federal, mandate a bill and keep intercarrier compensation regime? Second, if so, can that commission be the FCC? Third, can the FCC mandate bill and keep on the condition that it allows carriers to recovery their transport and termination charges from end-users.

In the Local Competition Order, the FCC permitted states to authorize bill and keep regimes in situations where traffic is balanced between the carriers. When traffic is in balance, a carrier meets its mutual and reciprocal obligation through the provision of an approximately equal amount of transport and terminating services as it receives from the other carrier. When traffic is out of balance, a net payment is made by the carrier with the higher originating traffic volume.

In their initial comments, the large ILECs assert that the FCC can mandate a bill and keep regime as long the FCC allows carriers to recover their transport and termination costs from their end-users. For example, SBC states that, "[a] mandatory bill and keep regime appears to be consistent with the reciprocal compensation provisions of the Act, provided that the Commission ensures there are end-user recovery mechanisms in place."[73] BellSouth states that, "[i]t (the FCC) has the authority provided that as part of a bill-and-keep mechanism, the Commission permits carriers to recover their cost from their end users."[74] They urge the FCC to reverse the Local Competition Order.

[73] SBC Comments at 43.
[74] BellSouth Comments at 17, *see also* Sprint Comments at 19, and QWEST Comments at 40.

OPC-DC, however, agrees with Focal, AT&T and the Office of Public Utility Counsel of Texas (TOPUC) and argues that the FCC can not mandate a bill and keep regime.[75] Section 252(d)(2)(B)(i) allows for bill and keep regimes. However, in order to establish such a regime, the carriers must waive their rights to cash compensation. If it is necessary for a carrier to waive its rights in order to establish a bill keep regime, then it not possible for the FCC to mandate such a regime. This is the position espoused by Pacific Telesis in the Local Compensation Proceeding when it argued that "Although parties may voluntarily agree to "waive mutual recovery," the Commission has no authority to require such an arrangement."[76] Bell Atlantic (now Verizon) noted that:

> The term "waive" means to "relinquish voluntarily (as a legal right)." See Websters Dictionary (1993); see also Black's Dictionary (6th ed. 1990) ("[t]o give up [a] right or claim voluntarily"). It does not, however, permit arrangements such as bill and keep to be imposed by regulatory mandate, whether in the context of an arbitration or as an interim measure.[77]

At that time, BellSouth asserted that, "[m]andatory bill-and-keep arrangements are unquestionably inconsistent with the plain language of the Act."[78] The Act has not been amended. It is still inconsistent with the plain language of the Act for any commission, federal or state, to mandate bill and keep.

Even if the Act would allow mandatory bill and keep, it is the state commissions, not the FCC, that has the authority to approve bill and keep regimes. Section 252(e)(1) directs carriers to submit interconnection agreements to state commission.[79] It is the state

[75] Focal Comments at 28-37, AT&T Comments at 36-41, and TOPUC Comments at 47-48.
[76] Pacific Telesis Group 96-98Comments at 95.
[77] Bell Atlantic 96-98Comments at 41.
[78] *Id* at 73.
[79] 47 U.S.C. §252(e)(1).

commissions' task to approve or reject the agreements. Moreover, Section 252(e)(5) allows FCC action only after a state commission has failed to act to carry out its responsibilities.[80]

Finally, Section 252(d)(2)(A)(i) states that each carrier has a "mutual and reciprocal" arrangement with the other carrier. This clearly implies that it is the other carrier that is responsible for the compensation.[81] The mutual and reciprocal relationship defined in this paragraph is not between the carrier and its own end-users or the end-users of the other carrier because end-users do not provide transport or termination service. Even though end-users will eventually pay for all the costs, they are not part of the reciprocal compensation transaction. That transaction is a wholesale transaction between carriers. Thus, bill and keep with recovery from end-users is not consistent with this paragraph. Instead, bill and keep can be used when traffic is in balance because then bill and keep represents mutual and reciprocal payments between carriers. When traffic is not in balance, bill and keep should not be used because one carrier has an obligation to pay the other carrier.

[80] 47 U.S.C. §252(e)(5).
[81] 47 U.S.C. §252(d)(2)(A)(i).

Conclusion

OPC-DC supports a reciprocal compensation regime which will provide the following benefits: (1) eliminate regulatory arbitrage, (2) promote competition in the local exchange marketplace, (3) lead to a more efficient, better-invested telecommunications network, and (4) help to maintain current levels of residential prices.

For the foregoing reasons, the OPC-DC urges the Federal Communications Commission to adopt a unified intercarrier compensation regime that is based on reciprocal compensation principles.

Respectfully Submitted,

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